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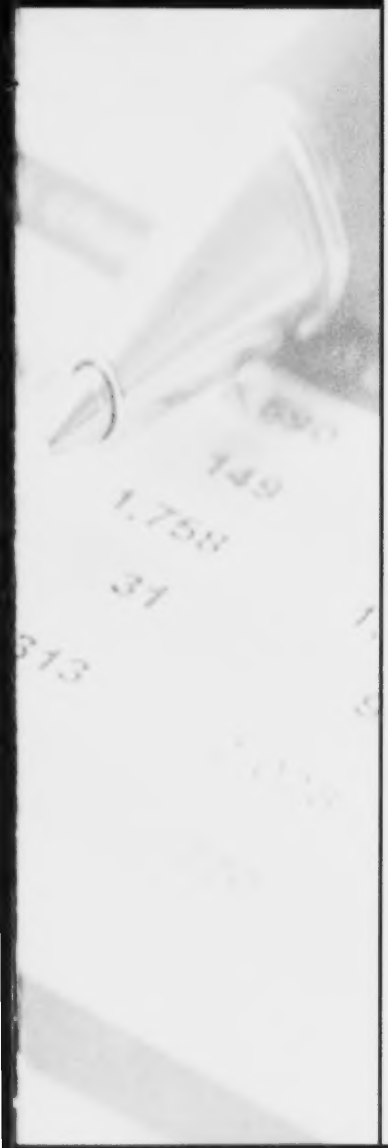
Ontario Commodity Futures Act Advisory Committee

Final Report

January 2007



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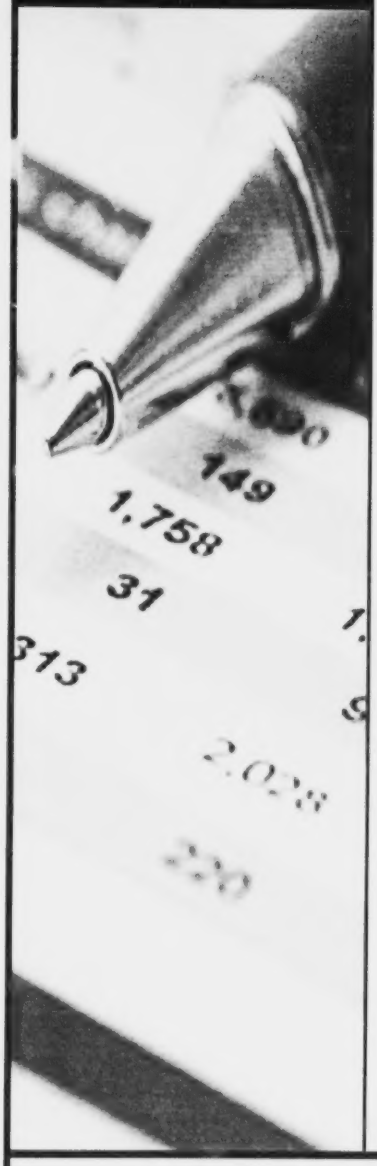

Ontario Commodity Futures Act Advisory Committee

Final Report

January 2007

Final Report to the
Honourable Gerry Phillips,
Minister of Government Services and
Minister Responsible for Securities Regulation

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Ontario Commodity Futures Act Advisory Committee

The members of the advisory committee (the Committee) appointed by Minister Gerry Phillips on May 26, 2005 to review *Ontario's Commodity Futures Act* (CFA) are pleased to submit our final report. When the Committee first met in June 2005, we brought different perspectives and personal views on the appropriate regulatory scheme for commodity futures and derivative products. Nevertheless, all members agreed that Ontario's Commodity Futures Act was outdated and no longer adequately addressed the marketplace as it had evolved.

The Committee's views and resulting recommendations developed as a result of a consultation process with a number of diverse groups and internal debate amongst Committee members. Although not every recommendation in our Final Report is a unanimous one, the recommendations do reflect a consensus of the Committee members.

The Committee sees this report merely as a first step to implementing a regulatory framework which will help maintain and foster strong Ontario participation in Canadian and international derivatives markets. The report recommends the implementation of new legislation rather than an amendment of the existing *Commodity Futures Act* but does not propose specific provisions for such legislation. The Committee is unanimous in its view that in the next step towards implementing a new legislative scheme, those considering this report should strive to ensure compatibility of the Ontario regime with the regulatory regime in other marketplaces, such as the United States and other provinces of Canada, where Ontarians participate.

The Committee would like to thank Ontario Securities Commission staff, and in particular Cindy Petlock, Manager, Market Regulation, for their assistance to the Committee. In addition, we express our appreciation to Margaret Grottenthaler who not only served as a member of the Committee, but also took on the task of coordinating the drafting of our report.

This, our final report, is respectfully submitted by the Committee.

Carol Pennycook, Chair

John Clark

Stephen Elgee

Margaret Grottenthaler

Paul Moore

Roger Warner

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The Advisory Committee and its Mandate

This is the final report of the advisory committee (the Committee) appointed by Minister Gerry Phillips on May 26, 2005 to review Ontario's *Commodity Futures Act* (CFA), as required by the statute. In advising the Committee on its mandate, Minister Phillips stated that the purpose of the review of the CFA is to ensure that Ontario benefits from a modern regulatory regime with strong investor confidence and protection. The news release and background regarding the appointment of the Committee and its mandate is attached to this report as Appendix I.

The members of the Committee are:

Carol Pennycook
(Partner, Davies Ward Phillips & Vineberg LLP, Chair of the Committee)

John Clark
(Chair & CEO, JCClark Ltd.)

Stephen Elgee
(President, Faversham Holdings Inc.)

Margaret Grottenthaler
(Partner, Stikeman Elliott LLP)

Paul Moore
(Vice Chair, Ontario Securities Commission)

Roger Warner
(Director of Operations, Canadian Derivatives Clearing Corporation)

Short biographies of the Committee members are appended to this report.

Since the introduction of the CFA, markets have evolved dramatically as a result of the introduction of new products, including a myriad of derivative products, innovations in technology and a marked trend towards globalization of trading. The Committee was advised that the CFA had not been reviewed comprehensively since its inception and, as a result, the CFA may not have kept pace with market innovation and evolution, and regulatory changes in other jurisdictions, including the United States which overhauled its commodity futures regime with the introduction of the *Commodity Futures Modernization Act of 2000*.

The Committee was requested to prepare a report which addressed whether the CFA, in its current form, provides an appropriate regulatory framework and, if not, to make recommendations as to a regulatory framework which would help maintain and foster strong Ontario participation in Canadian and international derivatives markets.

On May 26, 2006 the Committee released an interim report intended primarily for the purpose of soliciting further comment to the Committee with respect to commodity futures legislation and regulation of derivatives trading in Ontario. In preparing this final report the Committee has reviewed the comments and consulted further with the Autorité des Marchés Financiers (AMF) in Quebec. This final report supersedes the Committee's interim report. The Committee understands that the Minister will table this final report in the Legislature and a select or standing committee of the Legislative Assembly will be appointed to review the report, hear the opinions of interested persons or companies and make recommendations to the Legislative Assembly regarding amendments to the CFA and other legislation with respect to derivatives.

This report is solely a report of the Committee and the views expressed are those of members of the Committee and not of the Ontario Securities Commission (OSC) or the Province of Ontario.

The Review Process

The Committee's report will be the first statutory review of the CFA since it was enacted in 1978.

In preparing this report, the Committee reviewed summary comparisons of derivatives regulatory regimes in other Canadian jurisdictions, the United States, Europe and Australia. The Committee has conducted its review of the CFA to date primarily through review of regulatory frameworks for trading in commodity futures contracts and options on commodity futures contracts and other derivatives in various other jurisdictions, including other provinces of Canada, the United States and Europe, a review of the history of the CFA and consultation with various interest groups.

In Quebec a committee comprised of staff representatives of the AMF, with input from Quebec's derivatives industry, has undertaken substantial research and discussions over the past two years and, based on the work of that committee, the AMF has developed a report which summarizes its study of international best practices in derivatives regulation and provides a recommended road map for the development of derivatives oversight. The AMF report was released on May 25, 2006. The Committee had the benefit of reviewing the very comprehensive report prepared by the AMF and meeting with its representatives was also of great assistance in the preparation of this report.

The Consultation Process

The Committee determined that it wished to implement a consultation process to solicit input on appropriate regulation of commodity futures contracts and options on them as well as other derivatives from a number of sources, and to draw upon the experience of jurisdictions outside of Canada.

The Committee has reviewed background materials provided by staff of the OSC and OSC staff research undertaken at the Committee's request on a number of questions. The Committee would like to acknowledge and thank OSC staff for their assistance.

The Committee has also received input from representatives of the following organizations, either by meeting with them or via comment letters:

- The International Swaps and Derivatives Association
- Canadian Derivatives Clearing Corporation
- TSX Group Inc.
- Natural Gas Exchange
- The Commodity Futures Trading Commission in the United States
- The Derivatives Committee of the Investment Dealers Association of Canada
- Bourse de Montréal Inc.
- Winnipeg Commodity Exchange Inc.
- Autorité des Marchés Financiers
- Staff and Chair of the Alberta Securities Commission
- Staff and Chair of the British Columbia Securities Commission
- Canadian Bankers' Association
- Futures Industry Association
- Options Clearing Corporation
- Man Financial Canada Co.

Evolution of the Market

The CFA provides a regulatory regime for exchange-traded commodity futures contracts and options on commodity futures contracts, including the regulation of exchanges and clearing organizations carrying on business in Ontario, and other self-regulatory organizations and participants in this market. This report will refer to exchange contracts and options as CF contracts. The purposes of the CFA are to provide protection to investors from unfair, improper or fraudulent practices and to foster fair and efficient commodity futures markets and confidence in those markets.

When it came into force in 1979, the CFA implemented the recommendations contained in the "Report of the Interministerial Committee on Commodity Futures Trading" issued by the Ministry of Consumer and Commercial Relations in February, 1975 (the Bray Report). The Bray Report was prompted by concerns that trading in commodity futures contracts should be regulated; it was at that time largely unregulated. Regulation in the United States had recently been substantially revised. It was also recognized that existing securities legislation was not the appropriate means of regulating commodity futures contracts. Commodity futures markets at the time largely had as a goal facilitating the trading of actual physical commodities; they were not capital or investment markets. A prospectus regime focusing on disclosure regarding the "issuer" was not the type of regulation that would provide a participant, including a person speculating on the commodity market, with relevant information. As a result, the Bray Report recommended that commodities be regulated separately from securities where they traded on a recognized exchange. The recommendations were accepted and the CFA was enacted in 1978 and proclaimed into force on September 1, 1979.

As recommended in the Bray Report, the CFA focuses regulation on three main areas: the types of contracts; the marketplaces upon which those contracts trade; and the participants in those marketplaces. The CFA:

- restricts its reach to commodity futures contracts and commodity futures options (i.e. CF contracts),
- requires that exchanges with respect to CF contracts operating in Ontario be registered with or recognized by the OSC and comply with rules set out in the CFA,
- allows (but does not require) clearing organizations that clear contracts on recognized exchanges to be recognized by the OSC, and
- imposes dealer and adviser registration requirements with respect to trading in or advising on contracts on the recognized exchanges.

Since 1978 there has been significant evolution in each of these three areas; however, there have been very few changes to the CFA over that same period. Put very simply, the types of transactions, the nature of the market and trading practices have evolved far beyond what they were in 1978 and the current CFA no longer adequately addresses today's market.

Types of Contracts

At the time that the CFA was enacted, CF contracts related primarily to physical commodities, particularly agricultural commodities and, to a lesser extent, precious metals. The CFA regulates commodity futures contracts and options on commodity futures contracts. The definitions of "commodity",[1] "commodity futures contract"[2] and "commodity futures option"[3] serve as the basis of the existing regulatory framework of the CFA. The definition of "commodity futures contract" requires it to be traded on a commodity futures exchange, to require "delivery" of a specified quantity and quality, grade or size of a commodity, to provide for delivery during a "designated future month" and for that delivery to be at a "price agreed upon" when the contract is entered into.

The CFA definition of "commodity futures contract" does not easily encompass the wide array of derivative products which have come into existence. Today, many contracts worldwide relate to financial and other non-agricultural underlying interests, such as interest rates, foreign exchange, stocks, electricity and weather.

To address the growth in new underlying interests, regulations under the CFA may designate additional underlying interests as "commodities". Regulations have been enacted with respect to the newer products.[4] While regulations to the CFA expanded the list of eligible commodities, including cash settled products, the regulations do not fully address the expanded reality of derivatives trading in today's marketplace. The necessity to designate emerging underlying interests as "commodities" under the CFA has meant that new regulations must often be introduced to keep up with the market. The designation of additional commodities, in other words, has not always kept pace with the rapid development of products.

The CFA's definition of "commodity futures contract" is also too narrow. Many contracts are also now settled in cash or the book based delivery of an underlying commodity, instead of physical delivery of a commodity, and may be a contract for delivery during future days or weeks rather than months. This key definition does not easily encompass these cash-settled contracts.

[1] Section 1: "commodity" means, whether in the original or a processed state, any agricultural product, forest product, product of the sea, mineral, metal, hydrocarbon fuel, currency or precious stone or other gem, and any goods, article, service, right or interest, or class thereof, designated as a commodity under the regulations.

[2] Section 1: "commodity futures contract" means a contract to make or take delivery of a specified quantity and quality, grade or size of a commodity during a designated future month at a price agreed upon when the contract is entered into on a commodity futures exchange pursuant to standardized terms and conditions set forth in such exchange's by-laws, rules or regulations.

[3] Section 1: "commodity futures option" means a right, acquired for a consideration, to assume a long or short position in relation to a commodity futures contract at a specified price and within a specified period of time and any other option of which the subject is a commodity futures contract.

[4] See Rule 14-502 – *Designation of Additional Commodities*

The definition of "commodity futures contract" also affects the Ontario Securities Act (OSA). A CF contract that trades on an exchange that is not an exchange recognized by the OSC under the CFA is a "security" under the OSA, as that definition includes "any commodity futures contract or any commodity futures option that is not traded on a commodity futures exchange registered with or recognized by the Commission under the Ontario Commodity Futures Act or the form of which is not accepted by the Director under that Act". There are no definitions of the terms "commodity futures contract" or "commodity futures option" in the OSA, but the Committee believes that the prevailing view is that the general definitions in the CFA are the relevant definitions for purposes of the OSA.

Since the introduction of the CFA, the market has also seen the development of investment products that share characteristics of both securities and derivatives. These products, such as index-linked notes, hedge funds and options on securities, are regulated as securities under the OSA. This report will refer to these types of hybrid products as derivative-like securities. The restriction of the CFA to CF contracts trading on a recognized exchange to date has limited the overlap between the CFA and the OSA.

There has also been explosive growth in the market for negotiated over-the-counter (OTC) derivatives transactions since the enactment of the CFA. The retail market for OTC derivatives in Ontario is fairly limited at this time. However, certain traders and institutions are starting to market, or are interested in marketing, certain types of OTC derivative products, such as foreign exchange contracts, in Canada on a retail basis. Contracts for differences with respect to commodities such as electricity are also offered on a retail basis through OTC contracts. One can easily contemplate a wider offering of commodity hedging products to the retail public in the future (e.g. a hedge on the price of gasoline). These products are not CF contracts and are not, or might not be, "securities" as defined in the OSA.

Under the OSA, the OSC has rule making power with respect to "derivatives",[5] and has exercised that power to define "derivative" in Rule 14-501.[6] However, the OSC has not yet exercised its jurisdiction under the OSA in any comprehensive way with respect to OTC contracts. Nor has there yet been any study in Ontario as to whether the retail OTC derivatives market should be regulated by a securities regulator or how it should be regulated under securities laws, so as to provide guidance to the OSC with respect to the exercise of its rule making power. Where this report refers to OTC contracts it means derivatives transactions that are not entered into on an exchange.

[5] OSA, section 143(1), para 35.

[6] Rule 14-501, 1.1(3). See also the definition of "specified derivatives" in NI 81-102.

Marketplace

With the development of standard documentation such as the ISDA documentation, the OTC contracts market (which was not a material factor in 1978) significantly lowered transaction costs helping the OTC contracts market to grow rapidly. The strength of the OTC contract market as well as the development of new exchanges and marketplaces worldwide make it important to reconsider the regulatory regime that applies to CF contract exchanges and other marketplaces in Ontario in order to ensure that exchanges are competitive with and complementary to the OTC markets without compromising their safety and soundness.

Marketplaces for CF contracts have also evolved since 1978. The CFA concepts of providing for "recognition" of exchanges situate outside Ontario,[7] and "registration" of exchanges situate in Ontario[8] were introduced at a time when commodity futures exchanges operated by providing physical facilities for open-outcry auctions. It was, therefore, relatively obvious whether an exchange was situate in Ontario or not. With the advent of electronic trading, commodity futures exchanges have moved from being floor based to offering access through electronic trading systems.

Further, as market intermediaries develop electronic systems offering relatively standardized terms for entering into derivatives transactions to a wide class of parties it becomes more difficult to draw a clear line between what is, and should be, a regulated marketplace and what is a trading system that is simply a more efficient means of entering into a negotiated OTC contract. Those trading systems or marketplaces that bring together multiple buyers and sellers for trading on a non-discretionary basis, as opposed to bi-lateral trading arrangements, particularly need to be considered.

Clearing of transactions has also evolved. Separate clearing organizations have developed and are beginning to clear OTC contracts. Recognition of clearing organizations, even those that clear exchange traded contracts, is not mandatory under the CFA,[9] notwithstanding their significant role in the market.

[7] CFA, section 34.
[8] CFA, section 15.
[9] CFA, section 17.

Participants

Market intermediaries and other participants have evolved as the commodity futures industry has changed. Dealers and other participants have changed from being floor traders to conducting all trading electronically and have expanded into new business areas. The dealer and adviser registration requirements of the CFA apply only to CF contracts.

Over the last 30 years many statutory and administrative changes have been made under the OSA with respect to securities trading, including with respect to registration of market intermediaries. Corresponding changes have not been made to the CFA with the result that the laws and regulations, which were once consistent and compatible, now differ significantly without, in many respects, any supportable policy reason for the difference.

Approach of this Report

With this background and after considering many of the issues raised and discussed below, the Committee decided to analyze the issues and present its report in three sections. The first section (Part 3 below) considers what changes are needed to modernize the CFA and its regulation of CF contracts. The second section (Part 4 below) considers what the legislative regime, if any, should be for OTC contracts. The third section (Part 5 below) deals with registration issues, which would be relevant to either intermediation of CF contract trading or retail OTC contract trading.

This report does not deal at length with derivative-like securities. For the most part these types of products are already dealt with in the OSA. Further, the Canadian Securities Administrators and the federal Office of the Superintendent of Financial Institutions are continuing to study certain of these instruments to develop the appropriate regulatory response.

The Broad Themes

A New Law

The CFA has become so outdated that reforming it through amendments to the regulatory scheme of the CFA and its existing provisions is not practical. This view was echoed by those groups the Committee consulted who have had experience with the CFA.

This recommendation is not controversial. The more difficult issues are whether the new legislation should be separate legislation or a scheme of regulation integrated into the OSA, and what the broad content of that legislation should be. These issues are addressed below.

Committee Recommendation:
The CFA should be repealed and replaced with new legislation that is, at least initially, separate legislation from the Securities Act.

Compatible Legislation

The Committee notes that other provinces in Canada are also interested in updating regulation of commodity futures and derivatives. The importance of Ontario's regulatory framework being compatible with other markets, including not only other provinces of Canada, but also the United States, Europe and other jurisdictions to recognize the global nature of this marketplace, was a consistent comment to the Committee. In using the term "compatible", the Committee means that the regulatory scheme should not be in conflict with that of other relevant jurisdictions so that the participants in the Ontario marketplace may participate in the broader Canadian and global marketplaces in compliance with both the Ontario regulatory regime and the regulatory regime that applies in the other relevant marketplace.

Complete compatibility within Canada is impeded by the fact that different provinces currently take very different approaches to the regulation of these markets. In some provinces, futures contracts together with other derivatives are addressed in the relevant securities act; in others, including Ontario and Manitoba, separate legislation addresses exchange-traded CF contracts. Alberta and British Columbia have adopted blanket orders to provide broad exemptions for non–retail OTC contracts. These blanket orders are needed because of the extremely broad definition of a "future" in the securities acts in those jurisdictions that would include financial and commercial OTC contracts. These blanket orders, while similar, are not identical.

Consequently, in terms of compatibility in Canada, the Committee has been most interested in compatibility not with existing regimes, but with the proposals for reform in the leading jurisdictions. Ontario itself will be one of the leaders in Canada in this regard. Further, the flexibility of a core principles approach to regulation (discussed below) will allow for the development of compatible regulatory regimes without necessarily requiring the enactment of substantially similar legislation. Although the Committee believes that a regulatory regime for derivatives which is similar throughout Canada is desirable, it recognizes that implementing a single regulatory regime throughout Canada would be difficult to achieve in a timely manner. Further, the Committee heard from market participants, and agrees with them, that compatibility with U.S. regulation is at least as important, and probably more important, than compatibility within Canada.

Committee Recommendation:

Given the nature of the market, regulation in Ontario must be compatible (although not necessarily harmonized) with other Canadian regulatory regimes and, importantly, with the regulatory regime in the United States, and, to the extent feasible, other global markets in which Ontario participants take part. A fundamental principle of the new legislation should be to avoid unnecessary duplication of regulation between jurisdictions.

A Core Principles Based Regulation

The Committee is conscious of the desirability of flexibility in regulation to promote the competitiveness of the Ontario markets while maintaining regulatory oversight that ensures the integrity of those markets and protection for investors. Consequently, the view of the Committee regarding an appropriate regulatory framework is that it should be based on core principles, rather than prescriptive and specific rules.

The OSC, in its submissions to the Committee, noted the importance of a regulatory regime that provides flexibility to effectively respond to future developments and the need to harmonize any new derivatives regulation with changes made in the OSA and national instruments and rules that are applicable, and with other jurisdictions in Canada and with international practices.

The core principles approach has been adopted or recommended for other jurisdictions and it appears that it will ultimately be the approach that is favoured for North American securities markets. The AMF has recommended a core principles approach for Quebec. The United States Commodity Futures Modernization Act of 2000 (CFMA) as it amends the Commodity Exchange Act (CEA) adopts a core principles approach for United States markets and the U.S. experience since implementation has been positive.[10] The Canadian Securities Administrators (CSA) favoured a core principles approach to the regulation of securities markets as outlined in the Blueprint for Uniform Securities Laws for Canada, 2003. NGX has had positive experience under its currently principles-based regulation in Alberta. It is regulated in accordance with nine core operating principles established by the ASC which are aligned with the principles-based regime of the CFTC in the U.S.

The core principles approach would, or could, apply to the regulation of exchanges (and potentially other trading systems), clearing organizations, other self-regulatory organizations and participants. This approach reflects international trends and provides flexibility for regulation to adapt rapidly to complex and constant evolution of derivatives markets including continual introduction of new products and rapidly evolving markets.

Committee Recommendation:

With respect to its application to CF contracts, the new legislation should adopt a core principles approach to the regulation of exchanges (and potentially other trading systems), clearing organizations, other self-regulatory organizations and participants.

How that core principles approach should be reflected in the new legislation is somewhat more controversial. The OSC submitted to the Committee that the core principles be established by rule, policy or similar instrument and not be set out in the legislation. The AMF proposes that the core principles be set out in the Quebec legislation. The CFMA also sets out the core principles.

The OSC's recommended approach would provide the maximum level of flexibility to adapt to changing conditions. On the other hand, this approach gives the OSC an extensive and essentially legislative jurisdiction, albeit subject to governmental oversight and approval.

The Committee believes that the core principles should be set out in the legislation. They could

[10] See for example the testimony of Dr. James Newsome, President of the New York Mercantile Exchange, Inc. to the Subcommittee on International Trade and Finance of the Committee on Banking, Housing and Urban Affairs, United States Senate, October 18, 2005, page 2.

be sufficiently general to accommodate change in the markets under regulatory oversight without giving the regulator an unnecessary degree of autonomous jurisdiction. Core principles define the policy of the legislation. The legislature should define that policy.

Most commentators recognized the benefits of a core principles approach, but many also expressed concern that a core principles approach may not create enough certainty to allow participants to accurately assess their compliance with the law. The Committee believes that this legitimate concern can be addressed in part by expressing the core principles clearly in the statute. Specific rules providing certainty and guidance as to the application of the principles can be implemented by regulation under the legislation or by the OSC pursuant to a rule making power where they are needed. To the extent necessary further guidance can be provided through non-prescriptive policy statements providing examples of compliant systems or behaviours.

Committee Recommendation:

The core principles should be set out in the new legislation. Ontario should work with Quebec and other Canadian jurisdictions to endeavour to define a set of common core principles. In doing so it should consider core principles which have been adopted in other jurisdictions within Canada and the United States.

The Contracts: An Appropriate Definition

The definitions of "commodity" and "commodity futures contract" must be modernized. The need for flexibility recommends against specific definitions in the legislation of either the underlying interests or the types of contracts. As explained at the outset of this report, overly specific definitions have been problematic under the current CFA. Nevertheless, any legislation must define the scope of what is regulated or potentially regulated by the statute.

Many of the contracts that trade on futures exchanges do not involve commodities in the strict or even generously interpreted sense of the word. The underlying interests include rates, indices, equities, currencies, cost of services or even events, such as weather, or legal concepts, such as emissions limits. The contracts are not only those that provide for physical or book-based delivery of the underlying interest, but also cash-settled contracts for differences.

While they involve future performance or settlement, they are not necessarily futures contracts or even forward agreements as the market traditionally would have understood those terms.

The legislation must define what is a "commodity" and that definition, for purposes of this legislation only,[11] need not be restricted to commodities in the narrow sense of the term.

The OSC recommended a definition for a CF contract that would not limit the possible types of the specific underlying interest or possible features (such as contract expiration, physical versus cash settlement, etc.). Because the legislation would be restricted to exchange traded contracts and products, it is not necessary to circumscribe the definition as closely as it is for the regulation of OTC contracts (see the discussion below). Exchanges should have latitude in setting the standardized features of their contracts. It is, however, still necessary to provide statutory parameters. Generally, commentators on the Committee's interim report supported this approach.

Committee Recommendation:

The legislation should update the definitions of "commodity" and "commodity futures contract" and should define the types of CF contracts covered with reference to more generic qualities that do not define the specific underlying interests or the specific features of the contracts. An essential feature of CF contracts is that they are entered into on an exchange under basic contract terms set by the exchange.

Although the legislation is currently restricted to exchange traded products and contracts and does not deal with OTC contracts, it should be noted that some members of the Committee felt that it would be desirable to address all derivative transactions in a single statute. This is the approach which the AMF is proposing. As discussed in Part 4, on balance the Committee noted that the need for regulatory reform in the area of OTC contracts is not as pressing as it is with respect to CF contracts and, accordingly, recommend that, as an initial step, new legislation deal with CF contracts so as to avoid undue delay.

[11] Federal insolvency statutes, in the definition of "eligible financial contract", refer to "commodity contracts". In *Blue Range* (2000), 20 C.B.R. (4th) 187 (Alta. C.A.) the Alberta Court of Appeal defined the term "commodity" for purposes of this legislation.

Regulation of Markets

Recognition and Exemption of Exchanges

The CFA currently provides for both the "recognition" and "registration" of exchanges. It requires an exchange carrying on business in Ontario to be registered.[12] It enables an exchange located outside of Ontario to voluntarily apply to the OSC to be recognized.[13] The OSC considers an exchange to be carrying on business in Ontario if it offers direct remote access to a trader in Ontario. No exchange has voluntarily sought recognition under the CFA. As a result, CF contracts trading on foreign exchanges are treated as securities under the OSA. The OSA incorporated only the concept of the recognition of securities exchanges (not registration and recognition as under the CFA). The OSA requires a securities exchange that intends to carry on business in Ontario either to be recognized or to obtain an exemption from recognition. Generally, the OSC has granted exemptions from the OSA where the exchange is based outside Ontario and is subject to appropriate regulation by another regulator.

The CFA's split between recognition and registration reflected a time when providing direct access meant having physical facilities in Ontario. The distinction between recognition and registration enshrined in the CFA is no longer important or necessary. Commentators on the Committee's interim report supported this conclusion.

Committee Recommendation:

The two concepts of recognition and exemption that have in practice been applied to futures exchanges under the CFA, and that apply in other jurisdictions and under the OSA, should also be applied to the regulation of exchanges under the new legislation.

Only recognized or exempted exchanges should be permitted to carry on business in Ontario.

The legislation must provide specific guidance on what it means for an exchange to carry on business in Ontario. Only substantial connections to Ontario should trigger regulatory jurisdiction. Traditionally securities rules and regulations have looked to the location of an exchange's trading floor, the place of its organization, where it is managed from, whether it places dedicated terminals with traders in the jurisdiction, and what its home regulatory jurisdiction is.

[12] Section 15.
[13] Section 34.

Given that trading is now largely electronic, the global nature of these markets and the manner in which participants organize their operations, the location of particular physical, business premises or terminals will not always be relevant. If Ontario is the jurisdiction of the exchange where the head office, management and premises are located, it should clearly be subject to the recognition requirement. At the other end of the spectrum, if the only connection to Ontario is that its contracts are sold to Ontario residents through dealers registered to trade in Ontario, then that is not necessarily a substantial connection. Where an exchange has no substantial connections to Ontario, there should be no need for it to seek recognition, or to comply with specific financial, filing, reporting or other requirements of the OSC, simply because an Ontario market participant becomes a party to a contract listed on the exchange. Such an exchange, if regulated in a jurisdiction that is generally acceptable to the OSC, should be automatically exempted from Ontario regulatory requirements. Canadian or non-Canadian dealers that intermediate CF contracts on those exchanges may nevertheless have to be registered or exempt from registration.

The connections to Ontario that trigger prima facie regulatory jurisdiction do not have to be overly substantial if the exemptions are clear and relatively broad. What ultimately matters is a clear policy in favour of avoiding regulatory burdens arising from duplication of regulation of Canadian and non-Canadian exchanges. Where an exchange (or clearing organization or other SRO) is regulated in a jurisdiction that is generally acceptable, it should not be required to specifically seek an exemption from recognition or to comply with any Ontario regulatory requirements, such as audit, filing or rule review requirements.

Committee Recommendation:

The carrying on business test should be set out in the legislation and should be based on a substantial connection to Ontario. Careful thought should be given to what factors determine whether there is a substantial connection to Ontario and the legislation should provide guidance in this respect. There is a danger that too specific a definition could become outdated as trading practices change.

Automatic and complete exemptions from Ontario regulatory requirements should be available to exchanges whose contracts are sold to Ontarians, but that do not have a substantial connection to Ontario, if they are regulated in a jurisdiction with an acceptable regulatory regime.

Lead Regulator

A lead regulator model has been developed for securities exchanges in Canada. Under this model, several jurisdictions in which an exchange carries on business agree among themselves and with the exchange that one jurisdiction will be the lead regulator. The other jurisdictions recognize the exchange or exempt it from recognition, subject to terms and conditions. The agreement allows the regulation of the exchange to be conducted by the lead regulator pursuant to the rules of the lead regulator. The lead regulator shares with the other jurisdictions information and the benefits of the lead regulator's oversight. This model is not legislated under the OSA, but has developed through practice and memoranda of understanding among certain securities commissions.

Both the OSC and the exchanges the Committee consulted favour a lead regulator model for the recognition and exemption of CF contract exchanges. If the OSC has agreed to defer to a lead regulatory jurisdiction, then the exchange is, subject to any terms and conditions specified by the OSC, recognized or exempt from recognition without the need to comply with any specific Ontario requirements even if it is doing business in Ontario. The lead regulator model is in the interests of efficiency and compatibility with other regimes in Canada and elsewhere. The lead regulator model is also consistent with the concept of a single Canadian securities regulatory regime, which is supported by Ontario.

The regime should also be flexible enough that no specific agreement is required between the OSC and the lead regulator. In the case of non-Canadian exchanges regulated by a suitable regulator, the OSC may determine, subject to terms and conditions, to automatically rely on the regulatory oversight of the home jurisdiction regulator.

Committee Recommendation:

The legislation should entrench the concept of the lead regulator model by specifying that the OSC has the jurisdiction to enter into the types of agreements and arrangements that will allow it to implement a lead regulator model with respect to CF contract exchanges that carry on business Ontario.

The lead regulator model should also apply to exchanges regulated by non-Canadian regulators.

No reciprocity requirement should be imposed with respect to the recognition or exemption from recognition of CF contract exchanges based in other jurisdictions.

Tiered Regulation

In the United States, the CFMA created a new multi-tiered approach to boards of trade, with the degree of CFTC oversight and the legal requirements as set out in the statute dependant on the type of exchange. There are two types of regulated market and one exempt market provided for in the CFMA. With this type of regime the focus is not so much on definitions of what constitutes an exchange versus another type of execution facility, but on the degree of regulation appropriate given the participants in the market and the types of contract being traded.

The designated contract market[14] (DCM) is the only exchange market that may offer any type of product to any type of participant. It is subject to the highest degree of regulatory oversight. It must meet specified criteria, such as having the ability to prevent market manipulation, having rules and procedures to ensure fair and equitable trading, and having the ability to satisfy a comprehensive set of "core principles" on a continuing basis.

A derivatives transaction execution facility (DTF) is subject to fewer regulatory requirements than a designated contract market, but is subject to both product and participant limitations. It must have the ability to satisfy a less comprehensive set of core principles.

An exempt multilateral transaction facility (Exempt MTEF) is essentially an unregulated market, subject only to residual CFTC anti-fraud and anti-manipulation authority. Access is limited to "Eligible Contract Participants" and there are also product limits.

Neither the CFA nor the OSA contemplate a tiered regulatory approach to exchanges that carry on business in Ontario. All exchanges are subject to the same general statutory requirements for recognition/registration or exemption, but the type of exchange it is will influence whether recognition or an exemption is granted and the nature of the terms and conditions imposed as a condition to either recognition or exemption.

The OSC is not in favour of a tiered approach as part of the legislation. They prefer the flexible approach that exists under the current regimes. One commentator commented that the benefits of the flexible approach might marginally outweigh the benefits of a more formal tiered approach as long as the regulatory criteria were clear and reflected commercial reality and legal considerations.

The Committee has concluded that, while a tiered legislative approach might provide more legal certainty for market participants, given the size of the Ontario market this more complex approach should not be adopted at this time.

Committee Recommendation:

A legislated tiered approach to the regulation of CF contract exchanges should not be adopted at this time.

[14]Under the previous Commodities Exchange Act this was the only type of futures exchange.

Core Principles Applied to Exchanges

The current approach applied by the OSC for the recognition and exemption from recognition of exchanges under the OSA requires the exchange to meet a set of criteria and conditions for initial recognition or exemption and to meet various terms and conditions on an on-going basis. These terms and conditions are not provided for in the OSA. The terms and conditions are largely principle-based and are consistent with the core principles adopted for exchange regulation in the United States under the CFMA.

The OSC supports a core principles based approach to the regulation of CF contract exchanges and has adopted such an approach with respect to securities exchanges.[15]

The AMF also recommends a core principles approach.

The core principles would be broadly consistent with the International Organization of Securities Commissions' (IOSCO) Principles of Securities Regulation.[16] This approach provides a flexible regime but one that protects the safety and soundness of the markets. See the discussion above under Part 3 – Modernizing the CFA: A Core Principles Based Regulation.

Committee Recommendation:

A core principles approach for the recognition and regulation of CF contract exchanges should be adopted.

Exchange Rules – Self-Certification

The CFA currently requires every registered commodity futures exchange to file every by-law, rule and regulation (rules) with the OSC. The CFA also permits the OSC to make any decision with respect to a registered commodity futures exchange's rules. The OSC sets out the details of its rule review process, including prior approval of all new and amended rules, in the authorization order for each exchange. The OSC has implemented a practice, through recognition orders and rule protocols with some entities, to allow certain housekeeping amendments to rules to be deemed to be approved upon the filing of the amendment with the OSC.

The CFTC currently utilizes a self-certification process for rule approvals. Those maintaining a designated contract market status or designated transaction facility status notify the CFTC of rule changes and certify to the CFTC that the change meets the applicable core principles. The rule changes take effect immediately rather than following CFTC review and approval.

[15] See OSC Staff Notice 21-702 "Regulatory Approach to Foreign Based Stock Exchanges"

[16] IOSCO "Objectives and Principles of Securities Regulation", May 2003; IOSCO "Methodology for Assessing the Implementation of the IOSCO Objectives and Principles of Securities Regulation", October 2003.

Several Canadian exchanges advised the Committee that the process for prior approval of rules, including amendments to contract terms, is a significant impediment to their business. Prior approval of rule changes, many of which are uncontroversial and not material, and many of which are of benefit to market participants, can be time consuming and impair the competitiveness of the exchange in rapidly changing markets. Self-certification is important to ensuring that Canadian exchanges compete on a level playing field with other North American exchanges.

The AMF recommends a self-certification model for exchanges. The self-certification model would be defined in the legislation and the process for self-certification further defined by regulation. The process would require the filing in the lead regulator jurisdiction of any studies and analysis to support the new rule and demonstrate compliance with the core principles. Rule changes would be reviewed by the AMF, which would have the authority to recommend amendments.

Exchanges have an interest in ensuring that the rules they adopt to regulate their operations are effective, sound and acceptable to their participants. The need to certify that their rules comply with core principles provides the necessary assurance that the rules are appropriate.

The Committee considered whether there should be mandatory pre-publication of proposed rules or a mandated notice period before implementation of rule changes or certain types of rule changes. The Committee has determined that there is no strong policy reason to mandate pre-publication. Exchanges have strong market incentives to develop appropriate rules and to pre-publish in those situations where it is appropriate. Exchanges operate in a competitive environment and may have valid business reasons not to pre-publish a specific contract or other rule change. If a particular contract or rule is not appropriate, the market will respond more effectively and efficiently than a regulator could.

The Committee recommends that the OSC have the power to take punitive action against the exchange in the event that it certifies a rule change as being in compliance with core principles which is later determined by the OSC to not be in compliance with core principles. Punitive actions might include the imposition of fines and other censures, and the ultimate sanction of revocation, in whole or in part, of the privilege of self-certification. The Committee believes that it is not necessary to provide for any other consequence, such as an ability to require revocation of the rule change. The market and the ultimate sanction of punitive action will provide the required market discipline.

Committee Recommendation:

A self-certification model for recognized exchanges should be adopted where the OSC is the lead regulator of the exchange. The OSC should be notified of the rule changes and the exchange could be required to meet certain filing requirements that would be established by the OSC under a rule-making power. Under these conditions, rules could come into effect without prior review by the OSC.

The OSC's jurisdiction, set out in principle in the legislation and in more detail in implementing regulations, would be to review the changes. Rule changes which have been implemented which are determined by the OSC to not satisfy the core principles should result in punitive action against the relevant exchange.

There should not be mandatory pre-publication of rule changes.

The only regulatory consequence to an exchange of implementing a rule change certified to be in compliance with core principles, but which is not, should be punitive action by the OSC.

Alternative Trading Systems

Separate from the question of the tiered approach is the question of the appropriate regulation of alternative trading systems (ATS). Currently, the CFA regulatory ambit is limited to "exchange" trading only. In contrast, the OSA has the concept of marketplaces, contained in National Instrument 21-101, which is defined as follows:

Marketplace means:

(a) an exchange;

(b) a quotation and trade reporting system, and

(c) any other person or company that

(i) constitutes, maintains or provides a market for bringing together purchasers and sellers of securities,

(ii) brings together the orders for securities of multiple buyers and sellers, and

(iii) uses established and non-discretionary methods under which the orders interact with each other, and the buyers and sellers entering the orders agree to the terms of a trade;

(d) a dealer that executes a trade of an exchange-traded security outside of a marketplace.

This is broader than the exchange concept and has allowed for the introduction and regulation of ATSs as market intermediaries by the IDA and Market Regulation Services Inc., with additional marketplace reporting requirements.

The OSC submitted that the CF contracts legislation should include a concept of marketplaces. The goal would be to capture marketplaces that allow parties to enter into CF contracts. Any regulation must be sensitive to the distinction between a system that matches orders for instruments that trade, like securities, and a system that brings together parties to make an executory contract such as a CF contract or other derivative.

A number of commentators on the Committee's interim report agreed that it was appropriate to regulate ATSs. As with exchanges, regulatory jurisdiction should be based on a substantial connection to Ontario and ATSs should be subject also to a lead regulator model.

Committee Recommendations:

An ATS carrying on business in Ontario that brings multiple contracting parties together to enter into CF contracts should be addressed in the legislation and must be recognized by the OSC or exempt from recognition.

The core principles approach to regulation should apply.

The lead regulator model should apply.

Recognition and Exemption of Clearing

A clearing organization acts as a central counterparty (CCP) for contracts traded on securities, futures and derivatives markets by becoming the buyer to every seller and the seller to every buyer. Separate CCPs have been used by derivatives exchanges for many years and are increasingly used by securities exchanges. They have begun to provide their services in the OTC contracts markets, as well as markets for securities financing transactions.[17] The Canadian clearing organizations that the Committee consulted with indicated that they expect growth in this aspect of their business and CDCC has recently announced its entry into this business.

CCPs have the potential to significantly reduce risk to market participants by imposing controls on participants and by achieving multilateral netting of trades.[18] They can enhance market liquidity by reducing risk and facilitating anonymous trading.

[17] Securities financing transactions include securities lending, securities repurchase and reverse repurchase, and securities buy/sell back transactions. These are generally transactions where securities are transferred between financial institutions and other institutional investors subject to an obligation to retransfer equivalent securities (usually within one or a few days). The obligations to retransfer securities are fully collateralized, typically with cash collateral. The parties negotiate industry standard master agreements to govern their ongoing relationship.

[18] Committee on Payment and Settlement Systems and Technical Committee of the International Organization of Securities Commissions (IOSCO), *Recommendations for Central Counterparties*, November 2004, page 1.

However, they also concentrate risk and responsibility for risk management. A risk management failure by a CCP has the potential to disrupt the markets it serves and other aspects of the settlement and payment systems. Given the important role that CCPs play in the market, separate regulatory oversight is essential.

The current CFA allows the OSC, upon application, to recognize a "clearing house" for a registered commodity futures exchange. Recognition is not mandatory however, and is not provided for with respect to the clearing of off-exchange transactions. The Ontario government has amended the OSA requirements for clearing agencies, although the amendments have not yet been proclaimed into force.[19] These changes will require clearing agencies for securities to be recognized in order to carry on business in Ontario. There is mandatory regulation of clearing organizations for securities in the United Kingdom, the United States, Australia and Quebec.

Careful consideration must be given to what it means for a clearing organization to be carrying on business in Ontario. The test must relate to the clearing function itself as the organization might also execute transactions or engage in other activities. Further, it may be necessary to adopt different criteria for making this determination for clearing organizations, than for exchanges.

In the United States, under the CEA, as modified by the CFMA, designated clearing organizations (DCOs) are regulated separately from the market for which they provide the clearing services. Recognition can be extended by either the SEC or the CFTC depending on the products. In certain instances, recognition by the CFTC is not required, but may be granted to an applicant by the SEC or another federal agency (for example, regarding exempted commodities or excluded commodities). Recognition is based on compliance with core principles applicable to clearing organizations.[20]

The AMF also recommends a separate recognition process for clearing organizations and regulation based on a core principles model.

The same type of market risks arise in the concentrated clearing of off-exchange transactions as arise in the clearing of exchange contracts. Consequently, no distinctions should be made in terms of the general legislative scheme that applies to clearing off-exchange and exchange transactions.

For the same reasons set out above with respect to CF contract exchanges, a lead regulator model is appropriate for the recognition, exemption and on-going regulation of clearing organizations.

[19] S.O. 2005, c. 31.

[20] Based on the IOSCO core principles.

Committee Recommendations:

An organization carrying on business in Ontario as a centralized facility for the clearing of trades in CF contracts and/or OTC contracts should be required to obtain recognition, or be exempt from recognition.

The "carrying on business in Ontario" test should be set out in the legislation and should be based on a substantial connection to Ontario.

A CF contracts exchange seeking recognition from the OSC should be required to have its contracts cleared through a clearing organization recognized or exempted from recognition by the OSC.

Regulatory criteria should be tailored to organizations performing a clearing function; in other words, regulation of clearing organizations should be separate from regulation of the execution function of exchanges. Entities providing both services would comply with both compatible sets of regulatory criteria.

No distinction should be drawn between an organization that clears exchange traded contracts and an organization that clears off-exchange transactions, even those trading in an exempt or unregulated market.

The legislation should entrench the concept of the lead regulator model by specifying the OSC's jurisdiction to enter into the types of agreements and arrangements that will allow it to implement a lead regulator model with respect to clearing organizations that carry on business in Ontario.

The lead regulator model should also apply to clearing organizations regulated by non-Canadian regulators.

There should not be a reciprocity requirement with respect to the recognition or exception from recognition of clearing organizations based in other jurisdictions.

Core Principles for Clearing Organizations

For largely the same reasons set out above in relation to exchanges, a core principles approach to the regulation of clearing organizations is recommended. IOSCO and the Committee on Payment and Settlement Systems published "Recommendations for Central Counterparties" in November 2004 setting out a core principles approach to clearing organizations.

A core principles approach is consistent with the method of regulation recommended by the AMF, the method adopted in the United States under the CEA and CFMA, and the approach suggested above to the regulation for organizations offering execution services.

The AMF report recommends a common set of core principles that would apply to both exchanges and clearing organizations, but the AMF remains open to working with Ontario to determine the appropriate principles and the possibility that a different set of principles might apply to exchanges and clearing organizations. The OSC recommend that the core principles for clearing organizations should be tailored to those organizations and should not necessarily be the same principles as apply to exchanges.

Whether or not a common set of core principles for exchanges and clearing organizations is feasible will depend on the degree of generality adopted in the statement of the principles. The more general the principles, the more feasible it is to have common principles.

Committee Recommendation:

The new legislation should adopt a core principles based regulation of clearing organizations. Ontario should work with Quebec and other Canadian jurisdictions to endeavour to define a set of common principles based on the IOSCO principles for the regulation of clearing organizations.

Self-certification

CDCC favours a self-certification model for clearing corporations. Like exchanges, clearing organizations have an interest in ensuring that the rules they adopt to regulate their operations are effective, sound and acceptable to their participants.

Committee Recommendations:

A self-certification model should be adopted for recognized clearing organizations for which the OSC is the lead regulator, with a requirement that the OSC be notified of the rules changes and that the organization meet certain filing requirements that would be established by the OSC under a rule making power. Under these conditions, rules could come into effect without prior review by the OSC.

Under such a system, the OSC's jurisdiction, set out in principle in the legislation and in more detail in implementing regulations, would be to review the changes. Rule changes that have been implemented which do not satisfy the core principles should result in punitive action against the relevant clearing organization.

There should not be mandatory pre-publication of rule changes.

The only consequence to a clearing organization of implementing a rule change certified to be in compliance with core principles, but which is not, should be punitive action by the OSC.

Self-Regulatory Organizations

As under the OSA, the CFA provides for voluntary recognition of self-regulatory organizations, including exchanges (SROs). The IDA is the only non-exchange SRO to be recognized under the CFA. Under the CFA, no regulatory functions have been delegated to the IDA. Given the limited participation (until recently) of SROs in commodity futures regulation, very little consideration has been given to their appropriate regulatory role under the CFA.

A relatively new development in the securities industry has been the outsourcing of market regulation functions to a recognized SRO, Market Regulation Services Inc. Commodity futures exchanges presently retain their market regulation functions; however, it is conceivable that exchanges in future may wish to outsource certain functions in order to alleviate conflicts that might arise between members or shareholders and their functions, or to increase efficiency.

The AMF recommends that the outsourcing of certain functions, such as market regulation and monitoring and registration of participants, be permitted.

The CSA is currently studying the issue of SRO oversight. In its interim report the Committee specifically invited comment on whether self-certification is appropriate for SROs. Very few comments were received, no doubt because currently the market discipline function is performed by the exchange. Those who did comment believed that self-certification based on core principles would likely be the appropriate regulatory response.

Committee Recommendation:

Recognition of SROs should be mandatory and self-certification be further considered. Recommendations with respect to the issue of SRO oversight, including self-certification, should await further study by the CSA.

Anti-Fraud and Market Manipulation Rules

Market Manipulation and Fraud

The OSA includes a general anti-fraud and manipulation provision with respect to securities.[21] This provision is supplemented by National Instrument 23-101, Trading Rules, which deal with manipulation and fraud.[22] Persons and companies that comply with the rules, policies and instruments established by a recognized exchange, a recognized quotation and reporting system or a regulation services provider are exempt from the application of this provision. A companion policy to National Instrument 23-101 describes activities that would be considered to create a misleading appearance of trading activity or an artificial price.

A similar anti-fraud and manipulation provision has recently been added to the CFA. The language of the CFA provision is very broad and covers fraud and manipulation in contracts and/or commodities with respect to exchange trading. It reads:

> 59.1 A person or company shall not, directly or indirectly, engage or participate in any act, practice or course of conduct relating to commodities or contracts that the person or company knows or reasonably ought to know,
>
> (a) results in or contributes to a misleading appearance of trading activity in, or an artificial price for, a commodity or contract; or
>
> (b) perpetrates a fraud on any person or company.

[21] Section 126.1.
[22] Section 3.1.

There is no supplementing National Instrument, regulation or policy applicable to the CFA provision.

Exchanges and clearing organizations in both the United States and Canada have established additional procedures to prevent "cornering" and to detect attempts to corner markets early in the process. The activity of cornering the market involves purchasing a security or commodity in such a volume that control over its price is achieved. The objective is to make those with a short interest in the commodity pay an inflated price to cover the position or to secure the security or commodity in the cash market. The additional procedures impose two criteria on participants to eliminate the abuses in the derivatives markets: a reporting level and a position limit. A reporting level is the size of positions set by the exchanges, clearing organization and/or the regulatory entity at or above which commodity traders that carry these accounts must make daily reports. A position limit is defined as the maximum position, either net long or net short, on one commodity future (or option) or in all futures (or options) of one commodity combined that may be held or controlled by one person as defined by an exchange or regulatory entity.

In the United States, either the CFTC or the exchange/clearing organization establishes the reporting and position limits depending on the underlying interest of the commodity. In Canada, the MX and CDCC set the reporting and position limits on a per contract basis.

In the United States the core principles applicable to regulated entities include these requirements with respect to market manipulation and fraud. Anti-manipulation and anti-fraud provisions apply also to an exempt multilateral transaction facility.

With respect to oversight responsibilities, in the United States the CFTC has broad oversight powers, performs its own monitoring of trading and has a large enforcement staff. It is, however, regulating 13 different exchanges on a national basis. The CFTC has special powers of intervention that are quite far-ranging.[23]

The AMF recommends that it be the responsibility of the exchange's independently operated regulatory division, presently only the regulatory division of the MX, to oversee its markets on its behalf. The regulatory division's responsibilities can be built into the core principles. The AMF specifically notes that if other derivatives exchanges develop, the establishment of an independent SRO with the power to oversee markets could be appropriate.

There is currently no derivatives exchange based in Ontario. The OSC has been developing more experience in the regulation of derivatives and futures markets, but it is not a major aspect of their regulatory work. Imposing the sole responsibility for enforcing trading rules on the OSC may not be appropriate. General oversight of compliance by regulated entities with core principles and requiring those core principles

[23] Such as to raise margins, extend delivery periods, compel exchanges to allow delivery elsewhere than the location contemplated, request that position be closed, temporarily suspend a market or even impose a price at which all positions must be closed.

to address manipulation and fraud is a more realistic approach for the Ontario market. Sufficient flexibility in the legislation to permit the OSC to rely on regulation by an SRO, should the presence of exchanges develop in Ontario, would also be appropriate.

The Committee believes that this is an area in which the legislation should be flexible. Ideally a single national SRO should be possible without further legislation. The ability of the OSC to delegate jurisdiction to the lead regulator or an SRO itself regulated by another Canadian regulator should be possible.

Committee Recommendation:

The responsibility for oversight of the market should be shared with the existing regulated entities, adopting the same approach recommended by the AMF. As new exchanges appear, the OSC should have sufficient discretion to determine the appropriate approach.

Large Position Monitoring

The monitoring of large positions is intended to identify situations where a threat of market manipulation exists. This essential aspect of a market surveillance program for futures and options is carried out in Canada by the individual exchanges. In terms of CF contract exchanges, because there is little overlap in product, there has not developed a need for central monitoring. For example, monitoring of large positions on the MX is carried out by its own regulatory staff. No monitoring is currently performed by Canadian securities regulators.

In the United States monitoring of positions is carried out by the CFTC, which collects information from various sources and conducts a very in-depth surveillance program on the basis of the information it receives. The CFTC is authorized to impose limits on speculative positions in the commodity futures market.

The AMF has recommended against adopting as extensive an approach to monitoring as the CFTC's program because of the cost of such a program and the difficulty of detecting manipulation even with such a program. The AMF recommends a

system of severe deterrence penalties together with requirements imposed on exchanges to monitor trading. To the extent that derivatives exchanges develop that trade similar products, a system to centralize the information collected by all derivatives exchanges could be developed and managed by the AMF or an SRO.

The Committee agrees with the approach of the AMF.

Committee Recommendation:

The new legislation should address large position monitoring by implementing a system of deterrence penalties together with the power to require exchanges to monitor trading.

Regulatory Powers of OSC with Respect to CF Contracts

The Committee believes that further study is required of the types of enforcement and regulatory powers the OSC would require to effectively regulate under the new legislation.

Should CF Contracts Be Regulated as Part of The Securities Act?

The Committee heard different views on whether the regulatory regime regarding CF contracts should be integrated into the scheme of regulation in the OSA (i.e. treat them for the most part as securities) or should be in its own tailored, separate statute, such as the CFA, or a self-contained part of the OSA. The Committee's conclusion is that a separate statute is preferred at this time.

We heard from some commentators that the trend in the market is toward greater convergence between the characteristics of exchange-traded derivatives and securities and that the fundamental distinctions between them no longer exist. Dealers also regard exchange traded products and securities as fungible and would benefit from a similar regime applying to both. Essentially the legislation covers the same broad areas, namely disclosure, registration, exchange regulation, clearing regulation, investigation and enforcement. Other commentators, such as the TSX Group, specifically agreed with the Committee's preliminary view expressed in the interim report that a separate regime was the preferred approach. The AMF also prefers a separate legislative regime.

The Committee recognizes that there are disadvantages to two separate regulatory schemes. First, as has been demonstrated by the current situation, the two pieces of legislation

may start out as relatively consistent but over time inconsistent provisions can easily arise. Second, there can be uncertainty with respect to the treatment of products that straddle two regimes. Third, overlapping jurisdictions can provide opportunities for legal arbitrage, with issuers/offerors choosing the more beneficial regime. Fourth, administering two separate regimes may result in increased costs of regulation.

On balance, the Committee's recommendation is for a separate regulatory regime at this time. Treating exchanged traded CF contracts as separate instruments, with rules and regulations that recognize their unique aspects, will allow the government to better meet the objectives of flexibility within an efficient and sound marketplace.

As to whether the regulatory scheme for CF contracts should be in a separate CFA or in a self-contained part of the OSA, the Committee is concerned that much needed amendments to the scheme of regulation for CF contracts would be unnecessarily delayed if they were to be considered in the context of amending the OSA. The current OSA is not based on a core principles model. It would be difficult to implement a core principles model of regulation into the largely rules-based regulatory scheme of the OSA unless it was also being amended to move to a core principles based model of regulation.

To the extent that new legislation or regulation is to be introduced to deal with OTC contracts (as discussed later in this report) it may be appropriate to combine the regulation of CF contracts and OTC contracts in the same piece of legislation, albeit dealing with and defining those markets in different ways. OTC contracts also do not easily fit within the regulatory scheme of the OSA.

The regulation, whether in a separate act or separate part of the OSA, should nevertheless be as compatible as possible with the OSA, and the two statutes (or parts) should be monitored to ensure that market participants are not subject to conflicting regulation or that activities which should be regulated are not because they do not fall under either regulatory regime.

Finally, as discussed below, certain OTC contracts and other derivatives are currently potentially within the jurisdiction of the OSA.

Committee Recommendation:

At least initially, the new legislative regime with respect to CF contracts, exchanges and clearing organizations should be in separate legislation. The next best alternative is that it be in a self-contained part of the OSA.

Single Regulator

In Ontario, there is a single regulator of CF contracts and securities markets, namely the OSC. In the United States jurisdiction is split between the CFTC and the SEC, the result in part of the history of commodities regulation in the United States; this has not in many respects been an ideal situation in the United States. No one submitted to the Committee that a separate regulatory body for CF contracts would be appropriate in Ontario. It is appropriate to maintain the current single regulator structure.

Committee Recommendation:

The OSC should continue to be the designated regulator of commodity futures and exchange traded derivatives markets.

Areas for Reform and Policy Development

The Committee's mandate is to make recommendations as to a regulatory framework which would help maintain and foster strong Ontario participation in Canadian and international derivatives markets. International derivatives markets include the OTC contracts markets, and consequently, the Committee considered what types of reforms are required to enhance the ability of Ontarians to fully participate in these markets.

This requires consideration of the proper role of securities regulation in markets that are only in part investment markets. It also requires consideration of what other reforms might be required in order to create the required legal environment for the OTC contracts markets in Ontario. This may include not only legal certainty with respect to the application of securities laws, but also as to the enforceability of contractual rights. It will likely be the case that different definitions of what is an OTC contract would be needed for these different purposes.

While the AMF clearly sees itself as having a role in the regulation of OTC contracts, it must be remembered that the AMF, unlike the OSC, has jurisdiction in Quebec to regulate financial services generally, not just securities markets. For this reason, it may not be appropriate to adopt the same approach as is recommended by the AMF.

Role for Securities Regulation

A traditional security is generally a vehicle for investment regardless of whether it trades on an exchange. The exchange traded CF contracts market, on the other hand, is a zero-sum market for risk management and speculation. The OTC contracts market is largely a risk management market. Neither the CF contracts market nor the OTC contracts market is an investment or capital raising market. For the most part, OTC contracts are risk management products and financial products. While relatively standardized in terms of documentation, they are negotiated bi-lateral transactions entered into between financial institutions, institutional fund managers and other sophisticated end-users. To the extent they involve delivery of commodities, they can also be characterized as commercial market transactions. Securities regulators have little interest in regulating these financial or commercial markets and participants in those markets see no need to be regulated by securities regulators.

It is important to exclude commercial and financial markets from the scope of securities legislation. Contracts for the actual sale and delivery of commodities or risk management products offered by financial institutions can be inadvertently swept into the regulatory scheme unless the scope of the regulation is carefully considered and defined.

Certain markets which might overlap with a regime that covers OTC contracts are already regulated by regulators with special expertise. For example, the Independent Electricity System Operator has jurisdiction to authorize physical and financial market participants in electricity markets and the Ontario Energy Board licences sellers of electricity.

However, OTC contracts offered at a retail level, particularly over trading systems, do offer a means of speculating on (or investing in) movements in the underlying interests. While the retail market for such contracts is a nascent one in Canada, regulators have expressed concerns about fraud or the potential for fraud in the retail market. The OSC has expressed concern about trading practices and disclosure issues at the retail level. The Futures Industry Association in the United States has provided information indicating that fraud in the foreign exchange contracts markets at the retail level is a concern in the United States. There is a legitimate role for a securities regulator and for disclosure and intermediary registration requirements in the retail OTC contract market.

Participants in the broader OTC contracts market also require certainty as to the application (or more accurately non-application) of securities laws. Under the current law in Ontario there is uncertainty as to whether certain privately negotiated OTC cash settled contracts, where the underlying interest is a security, are governed by the OSA.

There is also some uncertainty as to whether other types of OTC contracts are subject to regulation as securities, such as currency forwards, arising out of the Pacific Coin case[24] and other regulatory decisions.[25]

The OSC has not yet exercised its rule-making power under the OSA to regulate OTC contract markets in any comprehensive way. The Committee believes that the OSC would benefit from further policy or legislative guidance to develop the appropriate regulatory framework for OTC contracts at the retail level. It may be that this regulation should be provided for in the new legislation that would also govern CF contracts.

While there is a role for the OSC in the regulation of OTC derivatives contracts, given the immaturity of the retail market for these contracts, the Committee notes that the need for regulatory reform in the area of OTC contracts is not as pressing as it is with respect to CF contracts. A number of commentators on the Committee's interim report expressed the view that reform with respect to CF contracts should not be delayed due to dealing with the unique and more difficult definitional issues around OTC contracts. For example, further consultation may be required to develop an appropriate legislative response with respect to fraud and market manipulation issues with respect to OTC derivatives contracts.

[24] *Pacific Coast Coin Exchange of Canada Ltd.* v. Ontario (*Securities Commission*), [1978] 2 S.C.R. 112.

[25] *Koman Info-Link Inc. (Re)* (2000), 23 OSCB 3974; *Yuen Chow International Group (Re)*, BCSC Weekly Summary, Edition 95:22 dated June 9, 1995; *Currency Specialist Ltd. (Re)*, BCSC Weekly Summary, Edition 95:22 dated June 9, 1995; and *Chinamax International Investment Ltd. (Re)*, BCSC Weekly Summary, Edition 97:13 dated April 4, 1997.

Committee Recommendations:

There is a role for securities regulatory oversight in the retail OTC contract market. There is not as immediate a need for reform in this area as there is for CF contracts. If it would result in delay in implementing CF contract reform to deal with OTC contracts, it would be appropriate to deal with OTC contracts at a later time.

The government should provide legislative or policy guidance to the OSC with respect to the regulation of "derivatives" in the retail OTC market.

Defining an OTC Contract

An important question is how securities legislation or regulation should define the retail OTC contracts market. This requires a definition for both the contracts and for a "retail customer".

In Canada and many other jurisdictions the preferred approach to date for defining a derivative contract is to define it extremely broadly and then to provide broad exemptions for the types of contracts not intended to be included. The preferred approach for defining the market is not to define what the retail market is, but to define what it is not (namely contracts between parties that fall within certain specified categories, such as banks, brokers, etc.). In the Committee's view, neither of these approaches is necessarily the most appropriate for the OTC contracts market.

The definition of derivative proposed in the proposal for a *Uniform Securities Act* (USA), for example, took the approach of defining very broadly the concept of a "derivative".[26] Similarly, under its rule-making power with respect to derivatives, the OSC has adopted a very broad definition of a "derivative". Rule 14-501 section 1.1(3) defines a "derivative" for purposes of the OSA as:

> *an instrument, agreement or security, the market price, value or payment obligations of which is derived from, referenced to, or based on an underlying interest, other than a contract as defined for the purposes of the Commodity Futures Act.*

"Underlying interest" is widely defined, for a derivative, in section 1.1(2) as:

> *the security, commodity, financial instrument, currency, interest rate, foreign exchanges rate, economic indicator, index, basket, agreement or benchmark or any other financial reference, interest or variable, and, if applicable, the relationship between any of the foregoing, from, to or on which the market price, value, or any payment obligation of the derivative is derived, referenced or based;*

[26] Canadian Securities Administrators, *Blueprint for Uniform Securities Laws for Canada, 2003.*

This broad definitional approach is also the approach we understand will be recommended by the AMF and it is the approach currently in place in Alberta and British Columbia securities legislation.

As these attempts to define a "derivative" demonstrate, it is a concept that is not possible to define without adopting a level of generality that renders the definition quite unhelpful. While they provide maximum flexibility and are attractive to regulators for that reason, broad conceptual definitions such as these have the disadvantage of inevitably creating uncertainty and potentially bringing within their scope transactions that should not be subject to the legislation. With a very broad and generic definition, there will have to be broad and generic exclusions in order to avoid an inappropriate legislative scope. Also, broad generic definitions compromise legal certainty, which is vitally important in these markets. In other words, definitions that are too broad will, in part, defeat the purpose of defining them.

The definitions of "derivative" proposed in the USA and adopted by the OSA are broad enough to cover every credit agreement and every sale of goods contract. ISDA provided comments to the CSA that criticized the proposed definition and the uncertainty it would create.

Traditional bank products could be caught by a broad definition of the contracts subject to the legislation under such an approach. In the United States the CFMA includes a new Title IV entitled "Legal Certainty for Bank Products Act of 2000". This Title excludes the application of the CEA to and CFTC regulatory authority over certain identified banking products, hybrid instruments that are predominantly banking products and covered swap agreements.

It is a complex law driven by the uncertainty created by the broad definitions in the CEA. The excluded bank products are:

- Identified Banking Products. Title IV provides an exclusion for all banking products in the market before the CFMA came into force.[27] New identified banking products are excluded if the product is not linked to and does not provide for delivery of any commodity (as defined in the CEA) or the product or commodity is otherwise excluded from the CEA.[28]
- Hybrid Instruments. A hybrid instrument that is predominantly a banking product is also excluded. There is a statutory process for determining the issue of predominance that involves both the CFTC and the Board of Governors of the Federal Reserve System.
- Banking products include accounts, certificates of deposit, bankers acceptances, letters of credits, bank loans, credit card debit accounts and loan participations sold to eligible contract participants.[29] The definition of bank includes a wider class of financial institutions than banks (but does not include dealers).

[27] Section 403. Subject to certain limits and to certification by the appropriate United States banking agency.

[28] Section 404.

[29] They are identified by reference to a test in the *Gramm-Leach-Bliley Act* as amended by the CFMA. GLB Act, section 206(a), (1) to (5).

- Covered Swap Agreements. Covered swap agreements are swap agreements relating to non-agricultural commodities that are between eligible contract participants and not effected on a trading facility or are traded on a principal to principal basis on an electronic trading facility if they relate to an "excluded commodity".[30]

If a broad definition of "OTC contract" or derivative were to be adopted as the basis of regulation of the retail OTC market, then it would be necessary to define an exemption or exclusion relating to bank products (perhaps similar to the identified banking products and hybrid products exemptions under the CFMA) so as not to interfere with the exclusive federal jurisdiction with respect to banking and so as not to be regulating what are essentially financial markets transactions. A more targeted definition would avoid many of these issues.

Insurance products might also be caught by any broad definition of the types of contract caught by the legislation.

An alternative approach, one similar to the current OSA approach and the approach in the Canadian insolvency statutes dealing with eligible financial contracts, is to develop a more specific list of the types of contracts that are derivatives, but also include a basket clause to capture similar agreements and easily accommodate future market innovation. The regulator could also be given the power to designate specific contracts if they fall within a class of similar contracts. In other words, the term "derivative", or whatever other term is used to define the contracts, has to be defined by example. Any attempt to create a generic definition will result in an over-inclusive definition.

Spot contracts should be excluded from the definitions, but there should be sensitivity to the definition of a spot contract so as not to exclude transactions such as rolling spot contracts.

As noted above, specific consideration should be given as to whether single stock futures should be dealt with as futures under the new legislation or as securities under the OSA.

Those commentators on the Committee's interim report who commented on these parts of the report agreed that the more targeted approach was appropriate; however, the Committee members were not unanimous in their view that a targeted approach as opposed to the broad definitional approach favoured by the AMF is appropriate.

Committee Recommendation:

The legislation should define "derivatives" for securities regulatory purposes with a list of the types of contracts captured, including in the list "similar contracts". Such contracts entered into with a "retail customer" would define the scope of the OSC's jurisdiction with respect to OTC contracts.

[30] Excluded commodities is a wide concept that includes interest rates, exchange rates, currencies, securities, credit risk measures, inflation indices and other macroeconomic measures or indices, commodities representing an occurrence or event outside the control of the parties to the transaction.

Consideration should be given to whether certain hedging contracts at the retail level should also be excluded. Any definition should take into account that there is a market for hedging transactions at the consumer and other retail levels that should not necessarily be subject to securities regulation. End-users in the OTC contracts markets are often hedging a financial or other risk. For example, a small housing co-operative might enter into a cash settled natural gas forward agreement with a gas retailer to hedge its commodity price exposure. A householder or a small municipality might enter into an electricity hedging arrangement with an electricity market participant or a contract for differences for his car gasoline requirements with a commercial market participant such as Petro-Canada. An individual might hedge the floating interest rate on its building loan by entering into a floating to fixed interest rate swap with a financial institution.[31]

Requiring providers of or dealers in these types of hedging products with end-users (including retail users) to be registered with the OSC or to provide a prospectus or similar document may not be necessary if the counterparty is a regulated financial institution, regulated by a regulator of the commercial market (e.g. licensed by the Ontario Energy Board and authorized by the Independent Electricity System Operator) or even a participant in the commercial market (e.g. a gas retailer such as Petro-Canada entering into cash settled gas forwards).

In certain circumstances, these types of transactions may be regulated as consumer transactions subject to general consumer protection legislation. Under the Ontario Consumer Protection Act a consumer transaction subject to the OSA or the CFA is excluded from the protections under the Act. If the new legislation is extended to all retail OTC contracts, then consideration should be given to whether they should or should not also be subject to the Consumer Protection Act. It may be that in certain cases it is more appropriate to provide the protections of the Consumer Protection Act. For example, a consumer entering into an electricity hedging arrangement through a door to door sales contract may expect to receive the protections under consumer protection legislation and the regulatory oversight of the OEB and the IESO, and not the regulatory oversight of the OSC. Similarly, regulation should not capture as "forwards" contracts that are settled at the time entered into and which simply provide for future delivery of an item or future payment of the previously agreed price.

[31] These parties would not meet the definition of "commercial user" in the Alberta and British Columbia Blanket Orders.

Defining the Retail Market

The AMF recommends bringing within the scope of regulation all derivatives contracts (broadly defined), whether they trade on an exchange, a trading system or are negotiated between parties outside of an exchange or trading system. Broad exemptions from registration and disclosure requirements would then be implemented through rules to exclude OTC transactions, other than at the retail level. It would do so through adoption of an "eligible parties" concept, namely that non-exchange transactions between eligible parties would not be subject to the Act. This approach of broad inclusion coupled with broad exclusions was also the approach recommended by the CSA with respect to the USA, except for Ontario. The approach is currently in place in Alberta and British Columbia where the Securities Acts apply to OTC transactions, but where the regulators have exempted from the prospectus and registration requirements, by blanket order, transactions between "qualified parties".

This approach was rejected by Ontario's then Minister of Finance when the OSC applied for approval of its proposed Over-the-Counter Derivatives Rule in 2000. The Minister's direction at that time was to identify the market that required regulation by securities regulators and to regulate only that market.[32]

The broad approach, as proposed for the USA and by the AMF, has been criticized by ISDA as creating unnecessary inefficiencies for counterparties who must determine whether they or their counterparties fit within any of the exempt categories. In commenting on the Committee's interim report, ISDA agreed that an attempt to positively define a class of "retail customers" was to be preferred, although it did note that there were few examples of legislative attempts to do so. ISDA recommends that a retail customer be defined as (i) an individual (including an individual's personal corporation), (ii) entering into an OTC derivative contract, (iii) for reasons unrelated to the individual's personal or business needs. The test would also exclude individuals who are accredited investors.

Other commentators remarked on the difficulty of developing an appropriate definition of a retail investor.

[32] The OSC published the following notice with respect to proposed rule:
On September 8, 2000, the Commission delivered Rule 91-504 Over-the-Counter Derivatives (the "Rule") and Companion Policy 91-504CP (the "Policy") to the Minister of Finance for approval under Section 143.3 of the Securities Act.
On November 2, 2000, the Minister returned the Rule and the Policy to the Commission for further consideration by the Commission of the need for the Rule, especially in regard to the balance between the costs and other restrictions on market participants and the objectives of the Rule, and whether the Commission's objectives in connection with the regulation of over-the-counter derivatives can be achieved by a rule that identifies the specific classes of transactions and related parties that will be regulated as opposed to having provisions of the Securities Act apply to all over-the-counter derivatives transactions and then providing exemptions from that application. The Minister indicated that a more detailed review of the nature and extent of any disclosure issues in retail over the-counter derivatives transactions would be helpful in determining the appropriate approach.

An approach that uses a complex set of definitions to define the scope of the market inevitably will result in situations where parties technically do not fit the definition of "accredited investor", "qualified party" or similar term, even though the relevant exemption should apply.

Set against these issues or potential problems are the benefits of compatibility with the regulatory approach in other Canadian jurisdictions, the United States and other jurisdictions. The scope of these regimes is defined in some fashion or another by the concept of an eligible participant.

On balance, the Committee remains of the view that it is more appropriate to endeavour to define what is the retail market (a positive definition), than to define what it is not through the adoption of an eligible participant or similar concept (a negative definition). However, the Committee recognizes that this may prove to be too difficult.

Committee Recommendation:

The legislative drafters should consider whether an appropriate definition of retail customer can be developed. If not, then they should develop the definitions of the exempt participants on the basis that the purpose of doing so is to define a class of participant requiring the protection of the legislation.

Securities regulation should not extend to financial or commercial OTC contract markets, including markets for derivatives transactions with retail customers.

Form of Regulation

The type of regulation that should apply to trading in OTC contracts that is subject to the legislation also requires consideration. As with securities regulation, disclosure and intermediary qualification are the fundamental considerations.

Prospectus-type requirements are not suited to the OTC contract market. There should instead be a requirement to provide clear, concise and easy to understand descriptions of the contract terms, the underlying interests and the risks inherent in the contract.

Registration requirements should also be flexible enough to accommodate participation by dealers who have expertise in particular types of products. For example, there may be energy market participants that have expertise in energy commodity trading but not securities trading generally. Also, banks would have expertise in currency trading.

Legal Certainty for the OTC Contract Market - Contract Enforcement

Because the legislation will directly regulate a contractual relationship between parties, we recommend that it specify the effect of non-compliance with the legislation or any of its exemptions on the enforceability of the contract. Legal certainty as to the enforceability of contractual rights is very important in these markets. In particular, market participants who are subject to the capital requirements based on the standards set by the Bank for International Settlements[33] must specifically address legal certainty in their risk assessment procedures. Capital requirements applying to transactions with parties from a jurisdiction can be affected where that jurisdiction's legal regime does not provide sufficient legal certainty. Because the exemptions to a large extent will rely on the characteristics of a participant that may not be easily ascertainable by its counterparty (i.e. are they retail customer), parties should be able to rely on representations as to status or the availability or applicability of exemptions.

The Committee believes that it would also be appropriate to include a more general safe-harbour, namely that no breach of the Act renders a transaction unenforceable. There could be regulatory consequences to such a breach, but contract rights would be secure. The modern common law position with respect to the effect of breach of a regulatory statute on the enforceability of a contract that is not compliant in some manner with the statute is to examine the policy of the statute and determine if it would be undermined by enforcing the contract. Where breaches have regulatory consequences it is generally not the case that the contract would be unenforceable. To provide a safe-harbour would be consistent with the modern position. It would clarify that certain earlier cases arising in the securities law context that rendered transaction in breach of the Securities Act void are not impediments to enforceability.[34] In OTC contracts, the parties will have common law rescission or damages rights arising out of negligent or fraudulent disclosure.

[33] Basel Committee on Banking Supervision as set out in *International Convergence of Capital Measurement and Capital Standards: A Revised Framework* dated November 2005, Found at http://www.bis.org/publ/bcbs118.htm.

[34] See, for example, *Jones v. F.H. Deacon Hodgson* (1986) 31 D.L.R. (4th) 455 (Ont. S.C.J.) which found a share subscription to be unenforceable on the basis of a breach of the Securities Act. See also *Northwestern Trust Co.*, in re *McAskill v. N.W. Trust Co.*, (1926) S.C.R. 412.

Committee Recommendation:

The legislation should specifically provide (a) that a contract is not unenforceable based solely on the failure of the transaction to comply with the terms of an exemption or exclusion provided for under the legislation and (b) that a party is able to rely on representations of the other party as to its qualification for any exemption provided for in the legislation, and (c) that no breach of the Act renders a transaction unenforceable.

It is similarly important that there be clarification that OTC contracts are not contracts of insurance or unlawful gaming contracts.[35] The prevailing legal view is that they are not, but the market would benefit from definitive confirmation of this position.

Committee Recommendation:

The legislation should specifically clarify that OTC contracts are not contracts of insurance or unlawful gaming contracts.

Certainty of Termination, Netting and Collateral Realization Rights

As part of the reform process for OTC contracts and, to a certain extent, CF contracts, the Ontario government may have the opportunity to consider and introduce other reforms that would protect Ontario derivatives and securities financing markets.

There is a need to create certainty under Ontario law with respect to the enforceability of termination, netting and collateral realization rights.

[35] The legal definition of what is a contract of insurance is ambiguous. In light of this ambiguity, because OTC contracts serve a risk management function and because payment obligations are dependent on uncertain events, there has been some uncertainty as to whether certain types of OTC contracts are contracts of insurance.

These protections are required not only for OTC contracts as they might be defined under securities legislation, but for any derivatives transactions documented as subject to termination and netting agreements. Accordingly, this could include CF contracts. It also includes a wider range of transactions, including securities lending, securities and commodities repurchase and reverse repurchase transactions (repos) and agreements for the purchase and sale of securities. The parallel concept in federal legislation is an "eligible financial contract".

Canadian federal statutes provide protections for termination and netting rights in eligible financial contracts in the context of federal insolvency proceedings.[36] Section 13 of the *Payment Clearing and Settlement Act* is not itself an insolvency statute, but it provides a protection for termination and netting rights in netting contracts between financial institutions notwithstanding any insolvency law or court order in an insolvency proceeding to the contrary.

> *13. (1) Notwithstanding anything in any law relating to bankruptcy or insolvency or any order of a court made pursuant to an administration of a reorganization, arrangement or receivership involving insolvency, where a financial institution or the Bank is a party to a netting agreement, the financial institution or the Bank may terminate the agreement and determine a net termination value or net settlement amount in accordance with the provisions of the agreement and the party entitled to the net termination value or settlement amount is to be a creditor of the party owing the net termination value or net settlement amount for that value or amount.*
>
> *(2) In subsection (1),*
>
> *"net termination value" means the net amount obtained after setting off or otherwise netting the obligations between the parties to a netting agreement in accordance with its provisions;*
>
> *netting agreement" means an agreement between two or more financial institutions or between the Bank and one or more financial institutions that is*
>
> *(a) an eligible financial contract within the meaning of section 22.1 of the Winding-up and Restructuring Act, or*
>
> *(b) an agreement that provides for the netting or set-off of present or future obligations to make payments against the present or future rights to receive payments.*

A similar type of statutory provision could be enacted in Ontario with respect to property and civil rights in the province regarding such contracts.

[36] *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3, s.65.1; *Companies' Creditors Arrangement Act*, R.S.C. 1985, c.C-36, s.11.1; *Winding-up and Restructuring Act*, R.S.C. 1985, c. W-11, s.22.1; *Payment Clearing and Settlement Act*, S.C. 1996, c. 6, section 13; *Canada Deposit Insurance Corporation Act*, R.S.C. 1985, c.C-3, s. 39.15(4).

ISDA and numerous other industry groups and market participants have requested further amendments to the federal insolvency legislation to ensure that realization of collateral for eligible financial contracts cannot be stayed in the context of a proceeding or by order of a court. The suggested amendments will also provide certain limited safe harbours from fraudulent preference and conveyance laws, in particular for top-up collateral. The recommended amendments are needed to bring Canadian laws into compliance with international standards.

Because certain provincial proceedings (such as receivership and corporate plans of arrangement) have the potential to stay or interfere with the exercise of contractual rights and because there are provincial fraudulent conveyance and creditor preference laws, it is important to adopt parallel protections under Ontario law for such financial transactions. This is an ideal area for uniform provincial legislation. The Committee would encourage the Ontario government to support a project to introduce uniform netting legislation.

Committee Recommendation:

The government should support the development of a uniform act providing a general statutory protection for termination, netting and collateral enforcement rights (subject to the Personal Property Security Act and Securities Transfer Act) with respect to derivatives contracts that would override any other provincial statute or judicial discretion.

Regulation of Participants

Any person or company that trades in (i.e., dealers) or acts as an adviser with respect to commodity futures contracts is required to register under the CFA or obtain an exemption. There are three categories of registration for advisers (commodity trading adviser, commodity trading counsel and commodity trading manager) and one category for dealers (futures commission merchant, or FCM). The CFA also provides some statutory exemptions from the registration requirement, for example trades by a hedger through a dealer.

The registration components of the CFA are outdated. There are numerous areas of the CFA's registration requirements that require reconsideration. In addition, while significant changes have been made over the last decade to the OSA's registration requirements, these changes have not been mirrored under the CFA. Given that Ontario is an active participant in the CSA's Registration Reform Project, an ongoing initiative to harmonize, streamline and modernize the securities registration regime across the country, the disparity between the two regimes will soon become even greater. Although the registration requirements and exemptions that are appropriate for trading and advising under the CFA do not correspond exactly to those that are appropriate with respect to securities, they are, in most respects, broadly the same.

In derivatives markets, because they encompass capital markets, financial markets and commercial markets (such as physical commodities markets), there will be intermediaries and advisors who have expertise in a particular aspect of the market. The registration system must be flexible enough to accommodate registration by entities that do not participate in securities markets without requiring them to meet requirements that would apply to a securities broker or dealer. For example, a participant intermediating transactions solely over NGX or NetThruPut should not have to meet proficiency requirements for the trading in securities or perhaps even futures trading generally.

The registration system should be flexible enough to accommodate the participation by intermediaries who may have a specialization in limited aspects of the derivatives market. This is particularly important in the context of OTC contracts.

The United States approach under the CEA has specific registration categories for derivatives, namely Futures Commission Merchants, Commodity Pool Operators, Introducing Brokers, Commodity Trading Advisors, Associated Persons, as well as Floor Brokers or Traders.

The Canadian market is not as complex or nearly as large as the United States market and the Committee believes that a formalized and complex categorization of registration may not be appropriate in the relatively small Canadian market. The AMF has expressed a similar view.

The Committee believes that the recommendations of the Registration Reform Project will be relevant to the consideration of requirements for regulation of intermediaries, including core principles related to integrity, proficiency and financial solvency for market intermediaries.

Committee Recommendation:

Further study of the appropriate registration requirements for the CF contracts and regulated OTC contracts markets should be undertaken once the Registration Reform Project is complete.

CF Contracts

General

1. The CFA should be repealed and replaced with new legislation that is, at least initially, separate legislation from the Securities Act.

2. Given the nature of the market, regulation in Ontario must be compatible (although not necessarily harmonized) with other Canadian regulatory regimes, and, more importantly, with the regulatory regime in the United States, and, to the extent feasible, other global markets in which Ontario participants take part. A fundamental principle of the new legislation should be to avoid unnecessary duplication of regulation..

3. The new legislation should adopt a core principles approach to the regulation of exchanges (and potentially other trading systems), clearing organizations, other self-regulatory organizations and participants.

4. The core principles should be set out in the legislation. Ontario should work with Quebec and other Canadian jurisdictions to endeavour to define a set of common core principles. In doing so it should consider core principles which have been adopted in other jurisdictions within Canada and the United States.

The Contracts

5. With respect to its application to CF contracts, the legislation must update the definitions of "commodity" and "commodity futures contract" and should define the types of CF contracts subject to the legislation with reference to more generic qualities that do not define the specific underlying interests or the specific features of the contracts. An essential feature of CF contracts is that they are entered into on an exchange under basic contract terms set by the exchange.

Exchanges

6. The two concepts of recognition and exemption that have in practice been applied to futures exchanges under the CFA, and that apply in other jurisdictions and under the OSA, should be applied to the regulation of exchanges under the new legislation.

7. Only recognized or exempted exchanges should be permitted to carry on business in Ontario.

8. The carrying on business test should be set out in the legislation and should be based on a substantial connection to Ontario.

9. The legislation should entrench the concept of the lead regulator model by specifying that the OSC has the jurisdiction to enter into the types of agreements and arrangements that will allow it to implement a lead regulator model with respect to CF contract exchanges that carry on business in Ontario. Careful thought should be given to what factors determine whether there is a substantial connection to Ontario and the legislation should provide guidance in this respect. There is a danger that too specific a definition could become outdated as trading practices change.

10. The lead regulator model should also apply to exchanges regulated by non-Canadian regulators.

11. No reciprocity requirement should be imposed with respect to the recognition of CF contract exchanges based in other jurisdictions.

12. A legislated tiered approach to the regulation of CF contract exchanges should not be adopted at this time.

13. A core principles approach for the recognition and regulation of CF contract exchanges should be adopted.

14. A self-certification model for recognized CF contract exchanges should be adopted where the OSC is the lead regulator of the exchange. The OSC should be notified of the rule changes and the exchange could be required to meet certain filing requirements that would be established under a rule-making power. Under these conditions, rules could come into effect without prior review by the OSC.

15. The OSC's jurisdiction, set out in principle in the legislation and in more detail in implementing regulations, would be to review the changes. Rule changes which have been implemented which are determined by the OSC to not satisfy the core principles should result in punitive action against the relevant exchange.

16. There should not be mandatory pre-publication of rule changes.

17. The only regulatory consequence to an exchange of implementing a rule change certified to be in compliance with core principles, but which is not, should be punitive action by the OSC.

18. An ATS carrying on business in Ontario that brings multiple contracting parties together to enter into CF contracts must be recognized by the OSC or be exempted from recognition. The core principles approach to regulation should apply. The lead regulator model should apply.

Clearing Organizations

19. A clearing organization carrying on business in Ontario as a centralized facility for the clearing of trades in CF contracts and/or OTC contracts should be required to obtain recognition, or be exempt from recognition.

20. The "carrying on business in Ontario" test should be set out in the legislation and should be based on a substantial connection to Ontario.

21. A CF contracts exchange seeking recognition from the OSC should be required to have its contracts cleared through a clearing organization recognized or exempted from recognition by the OSC.

22. Regulatory criteria should be tailored to organizations performing a clearing function; in other words, regulation the clearing function of clearing organizations should be separate from regulation of the execution function of exchanges. Entities providing both services would comply with both compatible sets of regulatory criteria.

23. No distinction should be drawn between an organization that clears exchange traded contracts and an organization that clears off-exchange transactions, even those trading in an exempt or unregulated market.

24. The legislation should entrench the lead regulator model by specifying the OSC's jurisdiction to enter into the types of agreement and arrangements that will allow it to implement a lead regulator model with respect to clearing organizations that carry on business in Ontario.

25. The lead regulator model should also apply to exchanges regulated by non-Canadian regulators.

26. There should not be a reciprocity requirement with respect to the recognition or exemption from recognition of clearing organizations based in other jurisdictions.

27. A core principles approach for the recognition and regulation of clearing organizations should be adopted. Ontario should work with Quebec and other Canadian jurisdiction to endeavour to define a set of common principles based on the IOSCO principles for the regulation of clearing organizations.

28. A self-certification model should be adopted for recognized clearing organizations for which the OSC is the lead regulator with a requirement that the OSC be notified of the rule changes and that the organization meet certain filing requirements that would be established by the OSC under a rule-making power. Under these conditions, rules could come into effect without review by the OSC.

29. The OSC's jurisdiction, set out in principle in the legislation and in more detail in implementing regulations, would be to review the changes. Rule changes that have been implemented which do not satisfy the core principles should result in punitive action against the relevant clearing organization.

30. There should not be mandatory pre-publication of rule changes.

31. The only consequence to a clearing organization of implementing a rule change certified to be incompliance with core principles, but which is not, should be punitive action by the OSC.

SROs

32. Recognition of SRO's should be mandatory and self-certification should be considered.

33. Recommendations with respect to the issue of SRO oversight, including self-certification, should await further study by the CSA.

Market Oversight

34. The responsibility for oversight of the market should be shared with the existing regulated entities, adopting the same approach recommended by the AMF. As new exchanges appear, the OSC should have sufficient discretion to determine the appropriate approach.

35. The new legislation should address large position monitoring by implementing a system of deterrence penalties together with the power to require exchanges to monitor trading.

Relationship with OSA

36. At least initially, the new legislative regime with respect to CF contracts, exchanges and clearing organizations should be separate in legislation. The next best alternative is that it be in a self-contained part of the OSA.

37. The OSC should continue to be the designated regulator of CF contracts markets.

OTC Contacts

Role for Securities Regulation

38. There is a role for securities regulatory oversight in the retail OTC contract market. There is not as immediate a need for reform in this area as there is for CF contracts. If it would result in delay in implementing CF contract reform to deal with OTC contracts, it would be appropriate to deal with OTC contracts at a later time.

39. The government should provide legislative or policy guidance to the OSC with respect to the regulation of "derivatives" in the retail OTC market.

40. Legislation should define "derivatives" for securities regulatory purposes with a list of the types of contracts captured, including in the list "similar contracts". Such contracts entered into with a "retail customer" would define the scope of the OSC's regulatory jurisdiction.

41. The legislative drafters should consider whether an appropriate definition of retail customer can be developed. If not, then they should develop the definitions of the exempt participants on the basis that the purpose of doing so is to define a class of participant requiring the protection of the legislation.

42. Securities regulation should not extend to financial or commercial OTC contract markets, including markets for derivatives transactions with retail customers.

Protection of Contractual Rights

43. The legislation should specifically provide that (a) a contract is not unenforceable based solely on the failure of the transaction to comply with the terms of an exemption or exclusion provided for under the legislation, (b) that a party is able to rely on representation of the other party as to its qualification for any exemption provided for in the legislation, and (c) that no breach of the legislation renders a transaction unenforceable.

44. Legislation should clarify that OTC contracts are not contracts of insurance or unlawful gaming contracts.

45. The government should support the development of a uniform act providing a general statutory protection for termination, netting and collateral enforcement rights (subject to the Personal Property Security Act and Securities Transfer Act) with respect to derivatives contracts that would override any other provincial statute or judicial discretion.

Regulation of Participants

46. Further study of the appropriate registration requirements for CF contracts and OTC contracts markets should be undertaken once the Registration Reform Project is complete.

CF Contracts

1. The parameters defining the key terms of "commodity" and "commodity contract" under the legislation governing exchange traded contracts.

2. The substantial jurisdictional connections that should determine when an exchange or clearing organization is carrying on business in Ontario for the purpose of determining whether it is required to be recognized or exempted from the recognition requirement.

3. Precisely how the lead regulator model should apply to non-Canadian exchanges, clearing organizations.

4. The nature of the lead regulator model and self-certification model that would be appropriate for other self-regulatory organizations in the commodity futures business.

OTC Contracts

5. The types of OTC contracts, if any, that should be subject to the regulatory jurisdiction of the OSC.

6. How OTC contract/derivative contract and retail customer should be defined for purposes of setting the broad parameters of the OSC's regulatory jurisdiction.

7. The definition of those OTC transactions with consumers that should be subject only to the Consumer Protection Act.

8. The appropriate form of disclosure for retail OTC contracts.

Participants

9. How intermediaries should be regulated in light of the findings of the Registration Reform Project.

Biographies

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Partner, Davies Ward Phillips & Vineberg LLP practicing in corporate/commercial and securities law. Chair of the Commodity Futures Advisory Board for several years.

John Clark

Chairman, President and CEO of JC Clark Ltd. Involved in the investment industry for over 40 years. Held the position of Chairman of the Board of Governors of the Toronto Stock Exchange from 1995 to 1997.

Stephen J. Elgee

CFA, President, Faversham Holdings Inc. Steve spent his entire career at BMO Nesbitt Burns where he was involved in all aspects of the Equity Derivative business. He is currently a member of the board of directors of both the Montreal Exchange and the Canadian Derivatives Clearing Corporation (CDCC) and is a member of the Commodity Futures Advisory Board, a past chairman of the Toronto Futures Exchange and a past member of the S&P/TSX Index Advisory Panel.

Margaret Grottenthaler

Partner, Stikeman Elliott LLP. Partner in charge of legal research and writing. Practice specialization in OTC derivatives and other structured products. Co-author of The Law of Financial Derivatives in Canada (Carswell).

Paul Moore

Vice-Chair of the Ontario Securities Commission since February 2001. Prior to this, he was a senior partner with a major Toronto law firm, where he headed up a derivatives practice group.

Roger Warner

Director, Operations of Canadian Derivatives Clearing Corporation. Mr. Warner has been in his current role since March 2000. Since joining CDCC in 1992, he has held numerous positions within the Corporation including Project Manager for the Year 2000 effort and Director, Information Technology. Prior to 1992, Mr. Warner spent nine years in numerous Information Technology roles at Grafton-Fraser Inc.

Abbreviations

AMF	Autorité des Marchés Financiers
ATS	Alternative trading system
CCP	Central counterparty
CEA	Commodity Exchange Act (United States)
CDCC	Canadian Derivatives Clearing Corporation
CF Contracts	Exchange-traded commodity futures contract and options on them
CFA	Commodity Futures Act
CFMA	Commodity Futures Modernization Act of 2000 (United States)
CFTC	Commodity Futures Trading Commission
CSA	Canadian Securities Administrators
DCM	Designated Contract market under the CFMA
DCO	Designated Clearing Organization under the CFMA
Derivatives-Like Securities	Hybrid products such as index-linked notes, hedge funds and options on securities
DTF	Derivatives Transaction Execution Facility (CFMA)
Exempt MTEF	Exempt Multilateral Transaction Execution Facility
FCM	Futures Commission Merchant

Abbreviations

FIA	Futures Industry Association (United States)
IDA	Investment Dealers Association of Canada
IESO	Independent Electricity System Operator
IOSCO	International Organization of Securities Commissions
ISDA	International Swaps and Derivatives Association, Inc.
MX	Bourse de Montréal Inc.
NGX	NGX Group, a subsidiary of the TSX
OEB	Ontario Energy Board
OSA	Ontario Securities Act
OSC	Ontario Securities Commission
OTC	Over-the-counter
OTC contracts	derivatives contracts that are neither securities under the OSA or trading on an exchange regulated as a commodities exchange
SEC	Securities and Exchange Commission (United States)
SRO	Self-regulatory organization
USA	Draft Uniform Securities Act published by the CSA

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For Immediate Release
May 26, 2005

ONTARIO LAUNCHES FIRST REVIEW OF COMMODITY FUTURES ACT

Ensures Up-To-Date Capital Markets Legislation

QUEEN'S PARK – The McGuinty government is appointing an advisory committee to review Ontario's Commodity Futures Act (CFA), as required by statute, to ensure Ontario benefits from a modern regulatory regime with strong investor confidence and protection.

"It is important to ensure that commodity futures legislation in Ontario is up to date," said Chair of the Management Board of Cabinet Gerry Phillips. The purposes of the act are to provide protection to investors from unfair, improper or fraudulent practices, and to foster fair and efficient commodity futures markets and confidence in those markets.

Carol D. Pennycook, Partner at Davies, Ward, Phillips & Vineberg LLP and chair of the Ontario Securities Commission's Commodity Futures Advisory Board, has agreed to chair the committee conducting the first statutory review of the CFA.

"I'm pleased to be part of the process designed to make sure that regulation keeps pace with market evolution and innovation and changes in other jurisdictions," Pennycook said. "The government is taking an important first step in moving forward with updating and modernizing the commodity futures regulatory regime."

The government expects that the review committee will focus on reforms that will strengthen the legislative framework in Ontario and ensure that commodity futures legislation is up to date. The committee has been asked to develop an interim report by March 31, 2006 and to deliver its final report no later than September 30, 2006.

The Minister will table the report in the Legislature, as the act requires that a select or standing committee of the Legislative Assembly be appointed to review the report, hear the opinions of interested persons or companies and make recommendations to the Legislative Assembly regarding amendments to the act.

"We are looking forward to the advisory committee's recommendations," Phillips said. "Maintaining investor confidence in the integrity of our capital markets is vital for maintaining Ontario's competitiveness and commodity futures markets are an important part of our capital markets."

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Ontario

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May 26, 2005

REVIEW OF ONTARIO'S COMMODITY FUTURES ACT

Background

The Commodity Futures Act (CFA) requires that the Minister appoint, on or before May 31, 2005, an advisory committee to review Ontario's commodity future laws and the legislative needs of the Ontario Securities Commission.

Other legislative requirements include that:

- The Minister shall table the report of the committee in the Legislature; and
- Upon the report being tabled, a select or standing committee of the Legislative Assembly shall be appointed to review the report, hear the opinions of interested persons or companies and make recommendations to the Legislative Assembly regarding amendments to the Act.

This is the first statutory review of the CFA. The *Budget Measures Act (Fall) 2004* changed the timing of future reviews of the *Securities Act* as recommended by SCFEA in October 2004. Consistent changes were made to the CFA to stagger the timing of future *Securities Act* and CFA reviews.

Members of the advisory committee are:

Chair:	Carol Pennycook (Partner, Davies Ward Phillips & Vineberg LLP)
Members:	Stephen Elgee (Managing Director, Equity Derivatives Products, BMO Nesbitt Burns)
	John Clark (Chair & CEO, JCClark Ltd.)
	Margaret Grottenthaler (Partner, Stikeman Elliott LLP)
	Paul Moore (Vice Chair, Ontario Securities Commission)
	Roger Warner (Director of Operations, Canadian Derivatives Clearing Corporation)

The CFA was introduced in Ontario in 1979, based on legislation in the United States. It was written at a time when the futures markets were focused on agricultural products.

Since then, the market has evolved dramatically due to the introduction of new products and innovations in technology. The CFA has not been reviewed comprehensively since its inception and, as a result, the CFA may not have kept pace with market innovation and evolution, and regulatory changes in other jurisdictions, including the United States. (In 2000, the United States overhauled its commodity futures regime with the introduction of the Commodity Futures Modernization Act.)

The derivatives area is one of the most rapidly expanding components of global capital markets and it is prudent to review whether the CFA, in its current form, provides an appropriate regulatory framework.

Although no commodity futures exchange is currently based in Ontario, most participants in this industry are located in Ontario. In addition, the Toronto Stock Exchange (TSX) has recently acquired the Natural Gas Exchange (NGX), a gas and electricity exchange currently based in Alberta.

A review of the CFA will help maintain and foster strong Ontario participation in Canada's exchange-traded derivatives market.

Background: Definitions

Commodity: Whether in the original or a processed state, any agricultural product, forest product, product of the sea, mineral, metal, hydrocarbon fuel, currency or precious stone or other gem, and any goods, article, service, right or interest, or class thereof, designated as a commodity under the regulations;

Commodity futures contract: A contract to make or take delivery of a specified quantity and quality, grade or size of a commodity during a designated future month at a price agreed upon when the contract is entered into on a commodity futures exchange pursuant to standardized terms and conditions set forth in such exchange's by-laws, rules or regulations;

Commodity futures exchange: An association or organization, whether incorporated or unincorporated, operated for the purpose of providing the facilities necessary for the trading of contracts;

Commodity futures option: A right, acquired for a consideration, to assume a long or short position in relation to a commodity futures contract at a specified price and within a specified period of time and any other option of which the subject is a commodity futures contract;

Derivative: An instrument, agreement or security, the market price, value or payment obligations of which is derived from, referenced to, or based on an underlying interest, other than a contract as defined for the purposes of the *Commodity Futures Act*.

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